American Electric Power
1 Riverside Plaza
Columbus, OH 43215 2373

AEP
AMERICAN ELECTRIC POWER

The Honorable John D. Dingell, Ranking Member
Commerce Committee Democratic Office
564 Ford House Office Building
U.S. House of Representatives
Washington, D.C. 20515

May 8, 1997

E. Linn Draper, Jr.
Chairman of the Board
President and
Chief Executive Officer

Dear Mr. Dingell:

As you requested, enclosed are the answers of AEP to your questions of April 10, 1997 on electric industry restructuring.

As you may be aware, AEP supports the creation of a competitive electricity market. We believe that a competitive electricity market will give customers more choice, more satisfaction and competitive prices.

We also believe that in a restructured electric utility industry there is a critical Congressional role in ensuring a fair market, reciprocity among states and a level playing field for all competing generators of electricity, including public and cooperative power providers along with the investor-owned utilities. In enacting federal legislation, AEP urges the Congress to repeal the Public Utilities Holding Company Act or PUHCA, as well as PURPA, the Public Utility Regulatory Policy Act. As a final point, in addressing the significant issues involved with electric utility restructuring, we urge the Congress avoid coupling this debate with a comprehensive review of existing environmental regulation.

We appreciate the opportunity to offer you our views on restructuring and we stand ready to assist you and your staff in this historic and important legislative endeavor.

Sincerely,

E. L. Draper

E. Linn Draper, Jr.

Enclosure

1. **From you company's point of view, is it necessary for Congress to enact legislation bearing on retail competition, and why? If you favor legislation, please outline which issues should be addressed and how you think they should be resolved.**

Restructuring the electric utility industry to provide for retail competition will require new laws be enacted by both the states and the federal government. In developing these changes AEP unabashedly supports customer choice and the move to competition for the electric utility industry. We believe competition works, that it will be good for all customers, and promises a new and better way to provide energy services, for the benefit of all Americans. In preparing for a competitive marketplace AEP has developed a model for industry restructuring that sees the federal government providing oversight to the interstate generation market and interstate transmission service, with the states providing oversight of customer distribution or delivery service. A detailed description of AEP's model is appended to this response as Attachment A.

AEP's vision of a restructured electric utility industry recognizes that the generation of electricity will be a competitive business while transmission and distribution will continue to be regulated. To create an effective competitive market in the generation of electricity, today's bundled electricity services must be unbundled. Buyers would be able to obtain competitively-priced electricity, with separately-priced and regulated delivery services. Buyers and sellers would ultimately have access to transmission services in a wide, multi-state region which contains many generators.

In AEP's model of a restructured electric utility industry there is a critical Congressional role, in ensuring there is a fair market, reciprocity among states, and a level playing field for all competing generators of electricity, including public and cooperative power providers along with the investor-owned utilities.

Although we recognize Congress' role in enacting legislation to protect the environment, we strongly urge that such legislation, if any, be developed independently, separate from the electric industry restructuring initiatives.

In enacting federal legislation, AEP urges the Congress to repeal the Public Utilities Holding Company Act or PUHCA as well as PURPA, the Public Utility Regulatory Policy Act.

In a dramatically changing electric industry, PUHCA imposes unneeded restrictions and significant costs and confers no real benefits. Even now, before retail competition becomes a reality, registered public utility holding companies are already at a competitive disadvantage in respect to the wholesale competition that already exists. The provisions of PUHCA were important back in 1935 when this law was passed, but make little sense in the circumstances of today especially as we look to the competitive future.

PURPA is costing many investor-owned utilities billions of dollars that are passed on to customers. These laws -- PUHCA and PURPA -- are relics of the past that are unneeded in the present and will be roadblocks to the future if they are not removed.

The Power Marketing Administrations are another big level-playing-field issue. We believe the federal government should sell the assets of the five Power Marketing Administrations. We believe this should be done in an open-bid process which maximizes return to the federal treasury and to American tax payers.

The federal and state subsidies to utilities such as the Rural Cooperatives and the municipal utilities are inconsistent with efficient competition and a level-playing-field. As electricity competition grows, increasing distortions will occur if certain suppliers will continue to have access to special privileges such as tax-exempt financing, preferential purchase policies, and tax exemptions.

The Tennessee Valley Authority is another of these level-playing-field issues, and serious consideration should be given to the privatization of TVA.

As a final point, in addressing the significant issues involved with electric utility restructuring the Congress should avoid coupling this debate with a comprehensive review of existing environmental regulations. The givens for AEP's position on environmental issues are that environmental excellence must be maintained, electricity competition is going to happen, and environmental concerns exist and they will continue to exist independent of electric industry restructuring.

The Clean Air Act is arguably the flagship of U.S. environmental regulation. Since its inception, it has undergone several revisions, most notably

the Clean Air Act Amendments of 1990. Actions under the Clean Air Act have led to great strides in reducing not only SO_2 but also ozone, and the chemicals or precursors that combine to form it. Many communities and states have achieved or are well on the way to meeting USEPA's current ozone standard.

But some -- notably on the East Coast, in the corridor from Washington, D.C. up to Boston -- have not been able to come into compliance. There also happen to be high-cost utilities operating within this corridor -- and some high-cost utilities are understandably less than eager for the onset of full competition. Thus, utilities and others in the northeastern states have complained that increased competitive power sales will worsen their pollution problems.

Their contention is that what they call dirty-coal Midwest utilities -- and they have placed a certain focus on AEP -- are exporting ozone emissions to their states, and will blow even more ill wind their way in a competitive circumstance. They want tighter controls on coal-burning, Midwest power plants.

The issue is not whether emissions can cross state lines -- because they can, of course, and do. But the indicators are clear so far that long-distance ozone transport from Midwest to Northeast is not a significant reality, and reduced emissions from Midwest power plants would do extremely little to benefit the Northeast.

On days when ozone concentrations on the east coast are as much as 160 parts per billion, far exceeding the 120 parts per billion limit, shutting down Midwest coal fired plants would only reduce concentrations from two to six parts per billion.

An imposing overlay to this is just how the USEPA may be migrating its approach to pollution controls relative to electric industry restructuring. In other words, what signals do we take from the particulate and ozone standards that were proposed by EPA late last year? Legislators, on both sides of the aisle, are questioning the benefits of strict new standards when the air is already becoming cleaner. It is AEP's position that the proposed standards do not pass scientific scrutiny, and in fact would disrupt already-effective air quality programs across the country.

Late in 1996, Representative Pallone also proposed environmental controls as a condition of retail electricity competition. His proposal would have held up competition pending a Clean Air Act amendment to sharply reduce utility emissions of nitrogen oxide, sulfur dioxide, mercury, and carbon dioxide. It is specious, inequitable, and disingenuous to impose such controls, and to suggest to the public that air quality concerns can actually be resolved with emission controls on electric utilities alone.

Problems in the Northeast will not be solved without local controls including all sources of pollution in the utility, other industrial, and transportation

sectors. Electric utilities have historically been subject to environmental regulations. They have compiled an impeccable record of compliance, and going beyond compliance. It is well recognized in the utility industry that superior environmental performance makes good business sense. Customers and shareholders will put up with nothing less. At AEP we believe that those companies that meet environmental excellence will fare best in the new, competitive arena.

2. If the state(s) you serve has adopted or is considering adopting retail competition, what are your biggest concerns? Please be specific. Indicate how you are dealing with them and any recommendations you may have.

AEP provides electric service to almost seven million people in the states of Ohio, Michigan, Indiana, Kentucky, West Virginia, Virginia and Tennessee. Ohio, Michigan and Indiana are currently considering restructuring legislation and the other four states are in the process of conducting studies.

AEP is particularly concerned with helping to ensure consistency among the approaches of our seven states to deregulation as the Congress will be challenged to bring consistency to this process on a national basis. We have been and will continue working at both the state and congressional levels to inform legislators and their staff personnel about responsive and responsible legislation to achieve the benefits desired for our customers, employees and

shareholders. Towards that end AEP's model for industry restructuring that calls for state and regional approaches to be allowed to evolve through cooperative federalism. By this we are suggesting a positive working partnership be developed between the federal government and the states to foster a workable federal/state accommodation on electric and energy services competition.

3. Whether or not you favor federal legislation, please indicate your position on the following specific issues (to the extent not addressed in your responses):

a. *A Federal mandate requiring states to adopt retail competition by a date certain.* If retail competition is under consideration in the state(s) you serve, do you believe Congress should provide additional direction or authority?

AEP, consistent with its model for a restructured electric utility industry, does not oppose a Federal mandate requiring states to adopt retail competition by a date certain. Customer choice legislation however should allow for a one-to-two-year period for unbundling and a transition period of not less than five years to phase in full customer choice.

b. ***Recovery of stranded investment.*** **If the state(s) you serve already has adopted retail competition, how was this issue addressed and are you satisfied with the outcome? If your state(s) is considering adopting retail competition, how would you recommend that this issue be treated? Do you think Congress should enact legislation relating to stranded cost issues, and if so what would you recommend? Is securitization a useful mechanism for dealing with stranded costs, and whom does it benefit?**

The highest hurdle to overcome in moving the electric utility industry toward deregulation is the issue of stranded investment. The term itself has come to mean many things, i.e. stranded investments, uneconomic investments, regulatory assets, impaired assets, etc. AEP defines the issue as stranded commitments which include the following costs:

- Regulatory assets are costs that regulators have allowed the Company to defer on the balance sheet. These are primarily deferred Federal and state income taxes related to the practice of flow-thru tax accounting, but also include plant phase-in deferrals and deferred DSM costs.
- Stranded assets (also known as impaired or uneconomic assets) are created when the book value of an asset is greater than its market value.
- Stranded liabilities are liabilities on the balance sheet that will not be recovered under market rates. Most notably for the industry,

this would include the cost of above market purchase power contracts, including PURPA contracts.

The issue surrounding stranded commitments is one of recovery. To allow utilities full recovery of all stranded commitments does not allow customers the immediate benefits of competition whereas not allowing utilities any recovery of stranded commitments penalizes shareholders for actions prudently taken by utilities under regulation. Under either scenario one group benefits at the other groups' expense.

A recovery mechanism for stranded commitments should balance the interests of ratepayers with the interests of shareholders without defeating the benefits of competition or unfairly burdening others. On that basis, it should (a) be limited to a fixed transition period prior to the onset of full competition, (b) reflect incentive ratemaking concepts, (c) provide full recovery of regulatory assets and (d) provide recovery of stranded assets and/or stranded liabilities as determined by the state regulatory commissions but only after mitigation alternatives are considered.

On this basis, as described in AEP's model, during the transition period, rates would be fixed at an appropriate level based on state regulatory decisions, such that the utilities can take steps to achieve costs savings which they could retain. These funds would be used against an amortization of stranded

commitments. Full competition would commence at the end of the transition period with no further protections to the generation owners.

Providing recovery based on incentive rates during a fixed transition period prior to the onset of competition produces the most equitable result. Such an approach balances the interests of ratepayers and shareholders by providing the opportunity for recovery partly by adjusting rates and partly by requiring cost savings. Such an approach does not pervert the effects of competition because recovery is provided only during the transition period, during which time competition is not in effect.

The most equitable solution is to provide recovery of stranded commitments as determined by the state regulatory commissions during a limited transition period of not more than five years but prior to the onset of competition -- ideally a common date for all states.

AEP does not favor legislation at either the federal or state level that would mandate recovery of these commitments. An exception to this rule is that AEP favors federal legislation to address the recover of costs associated with nuclear power plant decommissioning and nuclear waste disposal.

c. ***Reciprocity.*** **Can states condition access to their retail markets on the adoption of retail competition by other states? Should Congress enact such a requirement? could such a requirement create an incentive for states with low electric rates not to adopt retail competition, in order to keep cheap power at home?**

The Commerce Clause of the U.S. Constitution prohibits any action by a state that burdens interstate commerce or results in economic protectionism through an out-of-state discrimination. Thus a state enacted law that would seek to limit the ability of out-of-state suppliers to compete with in-state utilities would be unconstitutional. AEP supports federal legislation that would authorize state enactment of a reciprocity requirement modeled on what the Congress enacted for the banking industry. Basically this legislation would empower states to impose reciprocity conditions as part of the regulation of the electric utility business within their borders.

4. If Congress enacts comprehensive restructuring legislation, should it mandate "unbundling" of local distribution company services? What impact would this have, and would the effects differ for various customer classes? Would this entail substantial expense, and who would incur any such costs?

Most industry observers agree that today's combined electricity services must be unbundled or separated in order to provide the benefits of competition most efficiently. The term "vertically integrated" is used to describe the way electric utilities are currently structured and operated. Vertically integrated

utilities provide the generation, transmission and distribution of electricity as a single product and usually at a single price. The electricity is produced at the vertically integrated utility's generating plant and delivered over its transmission and distribution lines to customers within a franchised area. Separating these functions would provide significant customer benefits. Customers could choose their ultimate supplier of electric energy, and energy delivery would remain stable and reliable.

5. Recently Chair Moler of the Federal Energy Regulatory Commission recommended that, as part of comprehensive legislation, Congress authorize the Commission to enforce compliance with North American Electric Reliability Council standards to help maintain reliability of service. Do you believe this is necessary, and why or why not?

As the industry evolves with a variety of new parties involved in the buying and selling of electric energy and the operation of electric facilities, the reliability of the operation of the electric power system must be clearly recognized as being of paramount importance. Notwithstanding the new commercial arrangements that will exist in the electric industry, the nation's interconnected power supply systems must be operated so as to avoid conditions that could result in widespread failures of the system. This requires that clearly defined policies and standards are necessary for the planning, engineering and operation of electric power supply systems. These polices and

standards must be followed by all parties that will have an impact on the operation of the power supply systems. Since the mid-1960s, following the Northeast Blackout of 1965, the North American Electric Reliability Council (NERC) and its Regional Council members have been the "keepers of reliability". NERC was formed as a voluntary organization of the electric utility industry to assure that all parties coordinate and cooperate in their operation and planning to assure the reliability and adequacy of the nation's power supply system.

As the industry is now evolving, so also NERC is changing to accommodate this change. All industry segments are being invited to participate in NERC and Regional Council activities. NERC has recently changed its by-laws to provide that all regions of NERC on behalf of its members commit to comply with all of the policies of NERC. In addition, NERC has initiated a codification of its reliability policies and standards to assure that they are clear and definable, can be measured, and compliance can be enforced.

NERC recognizes the key role it must play if the reliability of the nation's power supply system is to be assured in a new industry structure environment. NERC has many significant initiatives underway including developing the mechanism that will allow NERC to impose sanctions/penalties on industry participants that do not follow the NERC defined reliability standards. In this

regard, NERC is examining various self regulatory models that are applied in other industries, such as the banking, stock exchanges, etc. Depending on the outcome of such investigations, some form of legislative mandate may be required to provide support to this effort.

6. What concerns does your company have with respect to the role of public power and federal power marketing agencies in an increasingly competitive wholesale electric market? In markets in which retail competition has been adopted? Are there concerns you would like to have addressed if Congress enacts comprehensive restructuring legislation? Should Congress consider changes to federal law as it applies to regulation of public or federal power's transmission obligations?

The federal government and many state governments are promoting competition in electricity markets in an effort to reduce electricity prices to consumers and encourage economic growth. This is spawning fundamental changes in electricity markets, and the pace of change is likely to quicken in the future. In a competitive environment, federal and state subsidies to utilities are contradictory with efficient competition and distort the electricity market. The federal and state governments should not condone the emergence of a competitive electricity market that gives an unfair advantage to certain suppliers. As competition grows, increasing distortions will result if certain suppliers continue to have access to special privileges, such as tax-exempt financing,

preferential purchase policies and tax exemptions. These subsidies and competitive advantages should be repealed.

7. If Congress enacts comprehensive restructuring legislation, should changes be made to federal, state or local tax codes, and if so why? Please be specific.

[response to be developed]

8. What, if any, concerns do you have about the reliability of the electric system? If the industry moved to retail competition, will adequate reserves be available? Is the transmission system capable of handling full retail competition?

Regarding the movement to retail competition (i.e. full customer choice for generation supply), this question addresses two distinct but different aspects of reliability: a) what mechanism will be in place to assure that new generation will be constructed to provide an adequate generation supply in the future; and b) how is the security of the transmission system to be maintained if full customer choice takes place. These two issues, although distinct, are very much interrelated. The supply of electric energy to customers in a full retail wheeling environment will continue to be dependent on the reliable functioning of an integrated generation and transmission supply system. Currently, the power supply system is configured with distributed generating plants connected together with a transmission network to serve the distributed loads of retail

customers in defined franchise areas. Under the retail model, the physical and operational characteristics of the power supply system will not change, but the commercial arrangements between retail customers and generation suppliers will change dramatically, i.e. customers will have the freedom to negotiate power supply from nonfranchise area generation suppliers. The transmission network should be able to support such commercial arrangements, provided the physical and operational standards for the reliable functioning of the power supply system (integrated generation and transmission system) are not compromised. This means that the codification of the power system reliability standards, as described in the response to question 5, becomes a critical ingredient to the viability of retail wheeling.

Regarding the second part of this inquiry as to whether adequate generation reserves will be available when retail competition develops, this raises a host of new issues. Under the current regime, the vertically integrated utility is obligated to provide adequate generation reserves to meet its franchise area obligations. In a retail competition model, the individual utility no longer has an obligation to serve, and therefore, no responsibility to assure adequate generation supply. Instead, market forces will need to provide the appropriate price signal to encourage the development of new generation resources to meet market conditions. The development of those market signals is a complex undertaking that requires significant thought. Given the instantaneous nature of

electric power supply and the potential disastrous consequences of power supply shortages, this issue needs substantial public debate.

9. If Congress enacts legislation on retail competition, should changes to the Public Utility Company Holding Act of 1935 (PUHCA) be included? If so, what would you recommend? In particular, how should Congress address market power concerns in any such legislation? Are transition rules needed during the period before effective competition becomes a reality?

AEP believes that PUHCA should be repealed as soon as possible and that the repeal of this law should not await the development of retail competition legislation, or be tied to it.

As noted in our response to Question No. 1, even before retail customer choice is a reality, wholesale markets are highly competitive and PUHCA places unfair restrictions on only a handful of companies. Some of these restrictions include:

- Registered companies continue to be limited to the operation of a single integrated system;
- Registered companies continue to be restricted to investments in industries the SEC deems "reasonably incidental" to a utility system;

- Registered companies continue to require prior SEC approval before entering into any service, sales, or construction contracts with affiliated public utility companies;
- Registered holding companies continue to be prohibited from borrowing from subsidiaries, and loans from registered holding companies to their subsidiaries continue to be subject to SEC regulations;
- Registered companies continue to be subject to SEC regulation of their decisions to declare dividends or retire debt.

As the SEC stated in 1982 and again in 1995, PUHCA has accomplished its purpose and is no longer needed.

PUHCA was enacted solely to regulate the corporate structures and securities of utility holding companies to protect investors. PUHCA was not intended to address either retail service or competition issues.

Chairman D'Amato's stand alone PUHCA repeal bill, S. 621 will bring consumers and shareholders the benefits of PUHCA repeal. In addition, although we do not believe new regulatory authority is necessary, S. 621 provides federal and state regulators with access to books and records that the FERC and NARUC have requested.

In contrast to S. 621, the PUHCA reform sections of Chairman Schaefer's comprehensive legislation, H.R. 655, do not provide for outright repeal of

PUHCA. Rather, H.R. 655, provides that PUHCA "shall not apply" to those registered systems all of whose utility operating companies serve customers in states that have implemented retail competition.

As drafted, H.R. 655 could cause substantial implementation problems as well as significant competitive harm to certain companies. Because the applicability of PUHCA's restrictions would depend on the actions of individual states, different registered companies will find themselves subject to different federal regulatory requirements, depending upon the states in which they operate. Those companies that continue to be subject to PUHCA, because one or more states in which they operate are slow to implement retail competition, will be at a competitive disadvantage.

There is no need for Congress to address market power concerns in PUHCA repeal legislation. PUHCA was not enacted to address market power issues, and has not been enforced by the SEC as a means of protecting competition. Rather, the integrity of the market has been, and will continue to be, protected by the Department of Justice ("DOJ") under the federal antitrust laws, and through FERC and State regulation on terms and conditions of service.

PUHCA now prevents companies from engaging in economically efficient mergers, but PUHCA repeal would not lead to undue market concentration. Even after PUHCA repeal, mergers would need to be approved by state utility

commissions, the Federal Energy Regulatory Commission ("FERC"), and DOJ. Both the DOJ Merger Guidelines, and FERC's new merger policy statement bar the approval of any merger that would have an excessively anticompetitive effect.

Finally, because PUHCA repeal would have no anticompetitive effect, no transition rules are required during the period that retail competition is implemented.

10. To what degree, if any, have recent Securities and Exchange Commission administrative orders and Rule 58 decreased the need for legislative changes to PUHCA? Assuming these actions withstand any court challenges, what are your major remaining concerns about the Act?

We support the SEC's recent administrative orders and Rule 58. Any effort to rationalize the regulatory regime and to reduce unwarranted federal regulatory burdens benefits our customers and shareholders.

Unfortunately, as the SEC itself recognized in its 1995 report, the SEC does not have the authority on its own to eliminate the extraordinary and unnecessary burden that PUHCA imposes on registered companies, their consumers, and shareholders.

Although the SEC can decrease somewhat the number of transactions for which registered companies require prior approval from the SEC, and increase somewhat the registered companies' ability to take the same steps that exempt

and stand-alone companies can do today, as noted above, the registered companies continue to be subject to significant limitations not imposed on other participants in the utility sector or on any other industry competing for financing and investors.

Although the SEC has recognized that PUHCA is no longer required, Rule 58 and other administrative reforms of PUHCA are subject to recision or reinterpretation. Without the clarity of repeal, the registered companies continue to have potential limitations, the costs of which are to be borne by the registered companies' customers. Without the clarity provided by legislation, the registered companies may avoid reasonable investments that they could later be required to divest if the SEC changes course.

11. As electricity markets have become more competitive, some have asserted that PUHCA prevents consumers from receiving the full benefit of competition. Do you agree or disagree, and why? Is competition in wholesale or retail electric markets dependent upon the participation of the registered holding companies? Is it a certainty that changes to PUHCA would enhance actual competition? Please provide specific examples to illustrate your answers.

AEP believes that because PUHCA imposes costs and limitations on any company owning 10% or more of a public utility company, PUHCA acts to limit the number of companies willing to enter the electric power market, thus decreasing competition and increasing the cost of power paid by consumers. In

order to avoid PUHCA, new entrants are directed into only specific modes of competition, QFs, EWGs, or power marketers and some efficient modes of competition, or some competitive opportunities, are foregone. For example, pursuant to California's restructuring plan, California has encouraged the big three utilities in California to divest a significant portion of their generation assets. Ideally, the divestment would permit new market entrants to purchase the newly available plants and serve retail customers or the Power Exchange. But, few investors will want to subject themselves to PUHCA by purchasing facilities that cannot be held as QFs or EWGs. Thus, the price of the generation assets may be depressed, increasing the stranded costs that California's consumers will have to bear. Moreover, because of the smaller number of participants in California's energy market there may be less competition and higher prices.

12. Do registered holding companies face unique problems if some states they serve adopt retail competition and some do not?

[response to be developed]

13. How do the various retail competition proposals presently pending before the Congress affect decisions regarding stranded costs for registered holding companies? Do you support any of the formulations in these bills? Do you have alternate recommendations on this or other issues unique to registered holding companies if Congress enacts retail competition legislation?

[response to be developed]

American Electric Power
1 Riverside Plaza
Columbus, OH 43215 2373
614 223 1000

The Honorable John D. Dingell, Ranking Member
Commerce Committee Democratic Office
564 Ford House Office Building
U.S. House of Representatives
Washington, D.C. 20515

May 23, 1997

Dear Mr. Dingell:

Enclosed is AEP's answer to question number 7 of your April 10, 1997 letter regarding electric industry restructuring.

If you or your staff require any additional information, please call me at (614) 223-1608 or Earl Goldhammer, AEP's Tax Counsel, at (614) 223-1619.

Sincerely,

Edward J. Brady

Enclosure

cc: Bruce A. Beam
Earl Goldhammer

If Congress enacts comprehensive restructuring legislation, should changes be made to federal, state or local tax codes, and if so why? Please be specific.

FEDERAL

1. Federal law should continue to permit a corporation to spin off to its shareholders on a tax free basis a subsidiary containing part of its business assets.

Current Internal Revenue Code section 355 imposes a tight set of requirements on the ability to complete an entirely tax-free spin-off. These justifiably tight requirements are meant to prevent the distribution of corporate earnings in the guise of a business separation. Despite these tight requirements, there have recently been certain widely publicized perceived abuses to tax-free spin-offs. Legislation has been introduced (H.R. 1365 and S. 612) that would tax spin-offs as sales at the corporate level.

AEP believes that the aforementioned bills are too broad in scope and would tax spin-offs that are legitimate and may even be required. For example, if the electricity industry were deregulated, certain electric companies might be required to spin off certain of their assets or businesses to avoid anti-competitive market power issues. In these cases the electric company should not be penalized because of the excesses of other taxpayers. Any legislation in this area should be designed specifically to curb abuses. We should not throw the baby out with the bathwater.

2. Federal law should assure that "like-kind" property can be exchanged tax free.

Internal Revenue Code section 1031 permits like-kind property used in a trade or business or for investment to be exchanged without incurring tax on any gain which has accrued up to the year of the exchange. The exchanged property receives a "carry-over basis" thus deferring the recognition of gain until the acquired property is sold or otherwise disposed of in a taxable transaction. The purpose of section 1031 is to relieve taxpayers from paying tax when investments in like-kind property are continued and no liquid funds are available to pay tax on the accrued gain.

Unfortunately, Treasury Regulations promulgated under this provision adopt a very narrow view of what is "like-kind." If the electricity industry is deregulated, companies must have the ability to exchange, for example, generation equipment for transmission or distribution equipment. AEP believes that it is necessary to adopt a definition of "like-kind" that would permit assets used predominantly in the trade or business of the furnishing or sale of electric energy to be exchanged tax free for other assets used in the same trade or business.

3. Federal tax law should not favor municipal electric systems by permitting expansion of municipal facilities outside their present boundaries through the financing vehicle of tax exempt bonds.

Municipal electric systems are tax favored at the state and local level. If the electricity industry is deregulated, the federal tax law should not further encourage the expansion of these systems by providing federal tax benefits, such as tax exempt financing. The general taxpayer would then be subsidizing the electric systems of a relatively few customers. Further, such subsidization would distort any competitive regime that is adopted.

4. Rules permitting the deduction of contributions to Qualified Nuclear Decommissioning Reserve Funds should be updated to permit deductible contributions in the context of a deregulated electric industry.

Internal Revenue Code section 468A was adopted in 1984 to permit the current deduction of certain well-defined contributions by electric utilities owning nuclear generating plants to nuclear decommissioning funds. The law was designed to operate within the structure of a regulated electric utility industry. Its mechanics are dependent on traditional cost-of-service ratemaking principles.

Code section 468A needs to be modified so that even though a nuclear power plant owner does not receive regulated rates, such owner may deduct appropriate contributions to a nuclear decommissioning fund to assure that the fund is sufficient to cover necessary decommissioning costs.

STATE

1. State and local tax laws must be amended to assure that in a deregulated electric industry various types of electricity providers are taxed fairly.

Many states tax utilities, and specifically electric utilities, differently from general business taxpayers. Often utilities are more highly taxed than general business taxpayers. These higher tax costs are considered to be legitimate costs of service and are passed on to ratepayers in the form of higher rates. As a result, taxes are efficiently collected by state and local taxing authorities, but the political detriments of visibly high taxation are avoided.

Some states tax utilities more highly than others. Under deregulation, utilities will attempt to sell electricity to customers other than the customers located in their traditional service territories, including customers located in different states.

Utilities which must bear the burdens of high taxation are competitively disadvantaged when they attempt to sell their products to customers in states which do not impose high taxes on utilities.

This problem is particularly acute in the property tax area. States or localities which impose very high property taxes on utilities make it more difficult for those utilities to sell their products to customers in low tax states. On the other hand, utilities located in low tax states have an advantage because they can sell to customers in high tax states without having to pay high property taxes in the state where the customer is located because it is not necessary for the seller to have its own property there.

Efforts are being made in states with high utility taxes, particularly states which impose high property taxes on utilities, to have such taxes reduced. This is a particularly difficult effort because commonly property taxes are a major funding source for schools, and lowering property taxes means either that funds for schools are reduced or that new sources of revenue must be found.

2. Federal law should prohibit states from imposing more onerous property taxes on electric utilities than are imposed on other commercial and industrial taxpayers.

The federal government has assisted the railroad industry with respect to the imposition of high property taxes by states and localities with the enactment of the Railroad Revitalization and Regulatory Reform Act in 1976. Pursuant to 49 USCS sec. 11503, states and political subdivisions thereof may not levy property taxes against railroads that are higher than similar taxes levied against other commercial and industrial property. Further, railroads may seek redress in federal court to assure that unreasonably high property taxes are not assessed against them.

The electric industry would be materially assisted in its deregulation efforts if electric companies could be assured that states could not single them out for high property taxation. AEP believes that Congress should consider adopting property tax restriction measures for the electric industry similar to those that it has adopted in the railroad industry.

3. Nexus rules should be clarified to assure that a state may not tax electricity suppliers whose only relationship with the state is that the supplier has a customer there.

Several states impose gross receipts or gross income taxes on electric utilities which do business in the state. Under deregulation, electricity suppliers which do not do business in a state may still contract with customers in that state to supply electricity via the transmission and distribution lines of other companies. Such out-of-state providers do not have the traditional nexus for taxation with the state of their customers. However, at least one state, Pennsylvania, is attempting to assert its taxing jurisdiction over such suppliers. If such jurisdiction is successfully asserted, states will be able to assert their taxing authority nationwide with virtually no limits.

States have the ability to modify their tax regimes to avoid unapportioned gross receipts taxes and should not be permitted to impose gross receipts taxes on those

who do not have nexus with the state in violation of their due process rights. AEP suggests that Congress carefully monitor developments in this area to assure that states exercise their taxing authority only over taxpayers which satisfy constitutionally appropriate nexus requirements.